

**KELLEY DRYE & WARREN LLP**

A LIMITED LIABILITY PARTNERSHIP

**WASHINGTON HARBOUR, SUITE 400**

**3050 K STREET, NW**

**WASHINGTON, D.C. 20007-5108**

(202) 342-8400

FACSIMILE

(202) 342-8451

www.kelleydrye.com

NEW YORK, NY

LOS ANGELES, CA

CHICAGO, IL

STAMFORD, CT

PARSIPPANY, NJ

BRUSSELS, BELGIUM

AFFILIATE OFFICES

MUMBAI, INDIA

DIRECT LINE: (202) 342-8518

EMAIL: tcohen@kelleydrye.com

May 2, 2013

**Via ECFS**

Marlene Dortch, Secretary  
Federal Communications Commission  
445 12th Street, SW  
Washington, DC 20554

**Re: American Cable Association (“ACA”) *Ex Parte* Filing on the Connect America Cost Model, WC Docket No. 10-90**

Dear Ms. Dortch:

On April 30, 2013, Ross Lieberman (ACA), Ed Naef and Sam Kornstein (ACA consultants), and the undersigned, Thomas Cohen (Kelley Drye & Warren LLP), had a call with Talmage Cox and Heidi Lankau concerning the Connect America Cost Model (“CACM”) and the appropriate cost of capital. ACA submitted an *ex parte* filing on March 7, 2013 discussing its cost of capital calculations.<sup>1</sup> On the call, ACA stated that it had updated these calculations to treat the tax-shield in a manner consistent with Version 3 of CACM. We then described the various inputs that were included in the prior analysis to determine the cost of capital and indicated, based on these inputs, that the average cost of capital for the five ABC Coalition price cap LECs in aggregate was estimated to be in the range of 5.88 percent to 7.15 percent (depending on the averaging methodology).

After the call with FCC staff, ACA re-examined the input values and updated them to reflect changes in market-based firm-specific input assumptions. We also adjusted the market risk premium assumption to be consistent with the value of 6.7 percent filed by United States Telecom Association (US Telecom).<sup>2</sup> Further, while ACA agrees with US Telecom that the Capital Asset Pricing Model

<sup>1</sup> See *Ex Parte* filing of the American Cable Association in the Virtual Workshop in Response to the Public Notice, WC Docket Nos. 10-90 and 05-337, (Mar. 7, 2013).

<sup>2</sup> See Wireline Competition Bureau, Federal Communications Commission, Submission for the Record, Connect America Cost Model Virtual Workshop, Questions and Comments Posted Between March 26, 2013 and April 29, 2014, WC Docket No. 10-90 (Apr. 30, 2013).

KELLEY DRYE & WARREN LLP

Marlene H. Dortch  
May 2, 2013  
Page Two

("CAPM") is a common methodology used to estimate the cost of equity and has employed that model in its estimates using publically available market information, it does not agree that the Dividend Discount Model ("DDM") would be an appropriate cost of equity estimation approach, as this model is generally regarded as a valuation tool. As described in the Appendix to this filing, based on these updated values and amendments, ACA now estimates that the actual average cost of capital for the five ABC Coalition price-cap LECs in aggregate ranges from 5.21 percent-6.50 percent (depending on the averaging methodology).<sup>3</sup>

Should you have any questions about ACA's analysis, please contact me.

Sincerely,



Thomas Cohen  
Kelley Drye & Warren, LLP  
3050 K Street N.W.  
Washington, DC 20007  
202-342-8518  
tcohen@kelleydrye.com  
Counsel for the American Cable Association

cc: Talmage Cox  
Heidi Lankau  
Amy Bender  
Katie King

<sup>3</sup>

Since the Commission has historically used one discount rate for support determinations to maintain administrative simplicity, it would be appropriate to use a single discount rate that is a reasonable representation of the ABC Coalition member capital costs. ACA identified three approaches to averaging the price-cap LEC discount rates – even if each approach overcompensates certain price cap LECs relative to their cost of capital: a simple average (6.50 percent), an average weighted by total unserved (wireline) locations (5.84 percent), or an average weighted by firm market capitalization (5.21 percent).

While using different cost of capital assumptions for different carriers would be the most accurate modeling approach, it would add significant administrative complexity and would not be consistent with the approach of using global assumptions for other components of the cost model. Further, estimating average capital costs by using a sample of large providers as described above is consistent with the Connect America Fund Order requirement to model the costs of an efficient provider. See *Connect America Fund et al.*, WC Docket No. 10-90 et al., Report and Order, DA 13-807, ¶ 11 (Apr. 22, 2013) ("Connect America Fund Order").

## Appendix

### ACA Capital Cost Calculation

#### 1. Market Assumptions

Assumption	Value	Value Basis	Source
Risk Free Rate	2.00%	10-Y Treasury Yield	US Department of Treasury <sup>1</sup>
Market Risk Premium	6.70%	Market Premium	NYU Stern – Annual Risk Premiums for Stocks over T-Bills <sup>2</sup>
Tax Rate	39.3%	CAM	Default CACM tax rate inputs (34% Federal, 5.3% State) <sup>3</sup>
Unlevered Beta	0.51	Telco Utilities Beta	NYU Stern – Betas by Sector (Updated January 2013) <sup>4</sup>

#### 2. Company-Specific Assumptions & Cost of Capital Calculation

Assumption	AT&T	Verizon	Windstream	CenturyLink	Frontier	Source
Debt %	43%	61%	88%	52%	69%	Morningstar Debt % <sup>5</sup>
Equity %	57%	39%	12%	48%	32%	Morningstar Equity % <sup>5</sup>
Debt/Equity Ratio	0.76	1.59	7.26	1.07	2.17	Refer to Calculation 1
Levered Beta	0.74	1.00	2.76	0.84	1.18	Refer to Calculation 2
Equity Cost	6.99%	8.72%	20.48%	7.63%	9.93%	Refer to Calculation 3
Debt Cost	2.72%	2.60%	7.02%	5.02%	6.35%	Morningstar 10-Y bond YTM <sup>5</sup>
Cost of Capital	5.1%	5.0%	8.6%	6.3%	7.5%	Refer to Calculation 4

#### 3. Cost of Capital Weighting Factors

Assumption	AT&T	Verizon	Windstream	CenturyLink	Frontier	Source
1. Market Cap	\$203.15B	\$154.24B	\$5.03B	\$23.51B	\$4.15B	Yahoo Market Cap (4/13) <sup>6</sup>
2. Unserved Locations	6.8M	2.0M	1.4M	4.6M	0.3M	CAM Version 3 <sup>7</sup>

#### 4. Weighted Average Calculations

Weight Methodology/	Cost of Capital
Market Cap	5.21%
Unserved Locations	5.84%
Simple Average	6.50%

#### 5. Calculation Descriptions

Reference	Calculation
Calculation 1	(Debt %) / (Equity %)
Calculation 2	Unlevered Beta X (1 + (1 – tax rate) X ((Debt %) / (Equity %))
Calculation 3	Risk Free Rate + Levered Beta X (Market Risk Premium)
Calculation 4	(Equity %) X (Equity Cost) + (Debt %) X (Debt Cost)

<sup>[1]</sup> US Department of the Treasury: <http://www.treasury.gov/resource-center/data-chart-center/interest-rates/Pages/TextView.aspx?data=yieldYear&year=2012>

<sup>[2]</sup> NYU Stern – *Annual Returns on Stock, T.Bonds and T.Bills* : 1928 – Current: [http://pages.stern.nyu.edu/~adamodar/New\\_Home\\_Page/datafile/histretSP.html](http://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/histretSP.html)

<sup>[3]</sup> Default CACM tax rate inputs (34% Federal, 5.3% State), CQCapCostforCACM.xls', 'Capital Cost Inputs' Worksheet

<sup>[4]</sup> NYU Stern – *Betas by Sector (Updated January 2013)* : [http://pages.stern.nyu.edu/~adamodar/New\\_Home\\_Page/datafile/Betas.html](http://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/Betas.html)

<sup>[5]</sup> Morningstar Public Firm Bond Profile: <http://quicktake.morningstar.com/StockNet/bonds.aspx>

<sup>[6]</sup> Yahoo Public Firm Market Cap: <http://finance.yahoo.com>

<sup>[7]</sup> Connect America Cost Model Version 3, Support Model Detail Report